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ABSTRACT

This paper makes a contribution to the theory of the multinational enterprise (MNE) and, in particular, to why firms undertake foreign direct investment (FDI) rather than alternative strategies. We argue that FDI and its strategic alternatives involve different patterns of costs and returns over time, and hence different levels of risk and uncertainty. Traditional theories of the MNE conceptualize the firm as a risk-neutral decision-making entity with short-term efficiency objectives, and hence do not take these issues into account. This may be reasonable for firms with passive professional managers and widely-dispersed shareholders, operating in countries with the Anglo-American system of corporate governance. But many firms operate under quite different systems of corporate governance where concentrated shareholdings are commonplace and markets for corporate control are weak or non-existent. In these cases, shareholders exert considerable influence on all aspects of firm strategy including FDI. Furthermore, different groups of shareholders (State, family, institutions) are likely to have different objectives, different attitudes towards risk, and different decision-making time horizons. We thus suggest that the traditional theories of the MNE need to be extended to embrace consideration of corporate ownership (and other governance dimensions).

Keywords: MNE theory; corporate ownership; foreign direct investment; licensing; explorative and exploitative knowledge activities.

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INTRODUCTION

The various theories of the multinational enterprise (MNE) address the issue of why firms choose to extend their operations overseas through foreign direct investment (FDI) rather than via alternative strategies such as licensing. Notwithstanding their differences in emphasis, the “traditional” theories of the MNE all view the MNE as an efficient institutional form for the cross-border exploitation of firm-specific advantages (FSAs) based upon assets such as technology, brands, marketing and management expertise[1]. But such theories have been challenged by the appearance of MNEs from the emerging economies (EMNEs) which appear not to possess significant FSAs, and whose FDI typically involves the augmentation of existing FSAs by the acquisition of assets overseas rather than the exploitation of existing FSAs.

This paper engages with this key issue of why firms choose FDI in preference to alternative strategies, and is purely theoretical in content. Our argument in brief is that all FDI typically involves a substantial commitment of resources which may not yield positive returns for many years. The extended time periods, the one-off nature of most FDI projects, and the cross-border nature of the activities all result in high levels of uncertainty and risk[2]. The required resources will typically include not only financial resources, but also entrepreneurial, managerial and knowledge assets, and thus involve different risk exposures. Our contention in this paper is that the traditional theories of the MNE are valuable, but are limited by their implicit conceptualization of the firm as a risk-neutral decision-making entity with short-term efficiency objectives. In reality, however, strategic decisions are not made by firms *per se*, but rather through the interaction of various stakeholder constituencies – notably the shareholders

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[1] We use the term “traditional” to differentiate the long-standing theories of the MNE from the more recent theories which has been inspired by the growth of EMNEs.

[2] Lessard (2013: 196-7) notes that definitions of uncertainty and risk ‘vary by discipline as well as by perspective so that there are many, often contradictory, framings. Economists by and large use the definition introduced by Knight that uncertainty refers to situations where many outcomes are possible but specific probabilities are not assigned, while risk refers to situations where specific probabilities can be attached. Financial economists, by contrast, tend to lump together uncertainties and volatilities and define risk as the product of a distribution of state-specific outcomes and a position or exposure, as in value at risk (VAR). Supply chain specialists coming from an operations research tradition typically focus on product demand volatilities and specific events.’ Here we adopt simpler definitions, and use the term ‘uncertainty’ to refer to situations where there is more than one potential outcome, but there is no ‘risk’ unless something (money, livelihood etc) is at stake. All investments involve commercial risk, but FDI also involves additional political, exchange rate, and cross-cultural risks. These systematic risks potentially offset any gains from the reductions in firm-specific unsystematic risks associated with the diversification of revenue streams. The risk associated with a particular strategic decision will thus depend upon the degree of uncertainty about the potential outcomes, the level of resource commitment (and whether or not this is irreversible), and the capabilities and expertise of those charged with implementing the decision.

and the top management team (TMT) - taking into account the perceived opportunities, resources and capabilities available internally or externally to the firm. Such considerations apply to all strategic decisions, including the decision to expand overseas through FDI. In many (advanced and emerging) economies which do not embrace the Anglo-American system of corporate governance, share ownership is often concentrated (in the hands of families, the State, or financial institutions), controlling shareholders exert considerable influence on firm strategy, the markets for corporate control are often thin or inactive, business groups are common, and short-term wealth maximization should not necessarily be assumed as the main corporate objective. In short, the extant theories need to be extended to embrace consideration of the different objectives, risk attitudes and decision-making time horizons of important stakeholders – notably the shareholders and TMT – in order to make them more generally applicable both to MNEs from advanced economies and to EMNEs[3].

Furthermore, we separately consider the cases of asset-exploiting FDI and asset-augmenting FDI[4], as the firm will be faced with different alternative strategies in each case. In the case of asset-exploiting FDI (as considered by the traditional theories), the main alternative is licensing production to a domestic firm in the host economy (assuming that local production in the host economy is preferred to exports from the home economy). In contrast, we argue that the principal alternative to asset-augmenting FDI will be the in-house development of the required resources and capabilities as it is unlikely that these will be obtainable through licensing arrangements. Each of these strategic alternatives involves different patterns of costs and returns over time, hence different levels of risk and uncertainty, and will thus be viewed with differing levels of enthusiasm by the different shareholder constituencies.

The paper is structured as follows. We first compare and contrast the key elements of five traditional theories of the multinational enterprise, viz: market power theory; internalization theory; the transaction cost theory; evolutionary theory; and the eclectic paradigm. Next we emphasise the limitations of the traditional theories, and in particular how all assume that the cross-border scope of the firm is determined by short-term efficiency considerations. We then contrast, on the one hand, the likely costs, revenues and risks associated with asset-exploiting FDI and licensing and, on the other hand, those associated with

[3] As Ronald Coase (1973: 104-105) observed, "There is no one decision which can be considered to maximize profits independently of the attitude of risk-taking of the businessman."
[4] Dunning (2000a) was perhaps the first to popularise the distinction between asset-exploiting and asset-augmenting FDI in the IB literature, though he readily acknowledged the pioneering contributions of Wesson (1993; 1995) and Makino (1998). A complementary perspective has also been provided by scholars of national innovation systems: see, for example, Edquist (1997) and Lundvall (2007).

asset-augmenting FDI and in-house development activities. In the following section, we discuss the meaning of efficiency in the context of strategic decision-making, and emphasise that it is necessary to consider the different objectives, decision-making time horizons, and attitudes towards risk of the various stakeholders involved. We thus propose that MNE theory should be extended to take account of the ownership structures of firms (especially in those countries where corporate ownership and/or control is exercised by powerful family, State or institutional shareholders) and the extent to which managers have discretion to pursue their own objectives. Our approach is theoretical, but we conclude with a set of potentially testable propositions. The final section summarises the discussion, and briefly indicates how decision-making may be constrained by active markets for corporate control and by product market competition.

THE TRADITIONAL THEORIES OF THE MULTINATIONAL ENTERPRISE

In this section, we outline the main elements of five important theories of the MNE, viz: market power theory, internalization theory; transaction cost theory; evolutionary theory; and the eclectic paradigm. We highlight the key insights of each theory, and emphasise two common limitations namely that, in each theory, (i) the firm is conceptualized as a risk-neutral decision-making entity whose cross-border scope is determined by short-term efficiency considerations, and (ii) no consideration is given to the ownership structure of the firm. Such a conceptualization may have applicability in firms where shareholdings are widely-dispersed and managers may be assumed to pursue short-term profit-maximising or cost-minimising objectives. But in many economies, particularly emerging economies but also many advanced economies, concentrated share ownership and other forms of corporate ownership are the norm, and shareholders may have different objectives and different decision-making time horizons. In such cases, it is unrealistic to theorise that the most efficient outcome in the short-term is the one that will necessarily prevail. In short, we would argue that the theory of the MNE needs to embrace considerations of corporate ownership.

Market Power Theory

Market power theory (Hymer, 1960, 1968, 1970; Kindleberger, 1969; Caves, 1971) sought to explain the industrial composition of FDI, and why firms own or control productive facilities in foreign countries. Hymer (1960) highlights the fact that many industries are not perfectly competitive, but are beset by structural market imperfections due *inter alia* to economies of scale, government interventions, product differentiation, and other imperfections in goods and factor markets. Firms in such industries thus enjoy varying degrees of market power, and Hymer asserts that such firms will seek to enhance their market power by direct investment overseas. He notes that MNEs have to bear additional costs (including the costs of communication and acquisition of information, the costs and risks of exchange rate fluctuations, and costs due to less favourable treatment by host country governments) relative to indigenous competitors. To prosper, MNEs must either have firm-specific advantages (FSAs) which they can exploit by FDI in foreign markets and thus enhance their market power, and/or acquire/collude so as to remove conflict with foreign competitors and increase market power. Hymer clearly believes that firms become MNEs to maximise the returns on their competitive advantages, but is ambivalent about the wider welfare effects. He notes (Hymer 1970: 443) that 'direct foreign investment thus has a dual nature. It is an instrument which allows business firms to transfer capital, technology, and organizational skill from one country to another. It is also an instrument for restraining competition between firms of different nations. [It is important to note] that the general presumption of international trade economists in favor of free trade and free factor movements, on the grounds of allocative efficiency, does not apply to direct foreign investment because of the anticompetitive effect inherently associated with it.'

Internalization Theory

Internalization theory (McManus, 1972; Buckley & Casson, 1976, 1998a, 1998b; Rugman, 1981) addresses the issue of why firms expand overseas through FDI (and thus become MNEs) rather than relying on arm's length contractual arrangements (e.g. licensing) to service the foreign market. Buckley & Casson (1976) highlight the fact that the production of most goods and services involve a range of interdependent activities, which are connected by flows of intermediate products. These intermediate products include not only semi-processed materials, but also various types of knowledge (R&D, marketing etc.) and expertise embodied in human capital, patents and other intangible assets. They emphasize that the markets for these intermediate products typically suffer from various transactional market imperfections, particularly when the activities are located in different countries, including: the costs of searching for, and negotiating contracts with, potential partners; buyer uncertainty about the value and nature of inputs; the costs of broken contracts, and litigation; the need to protect product quality and reputation; the absence of futures markets; inability to engage in practices such as transfer pricing and cross-subsidization, or to take advantage of government interventions, differential tax rates and exchange rate movements. These imperfections are particularly significant in the markets for knowledge-based assets and capabilities (e.g. R&D) and, in such cases, there is an incentive to forego any form of contractual arrangement and instead bring the activities under common ownership within an MNE.

It should, however, be noted that there are also internal transaction costs associated with organising the activities within the MNE. These internal transaction costs include the costs of acquiring and transmitting information; the costs of communication about complementary actions or of providing for them to be combined; and the costs of incentive schemes to align the actions of the members of the firm with the objectives of the firm (Buckley & Strange, 2011). The chosen governance structure will depend upon a comparison of the market transaction costs and the internal transaction costs, and the MNE will emerge as the efficient outcome if the market transaction costs exceed the internal transaction costs.

The Transaction Cost Theory of the Multinational Enterprise

The transaction cost (TC) theory of the MNE (Teece, 1977, 1986; Hennart, 1982, 2001) shares many similarities with internalization theory, including a common intellectual heritage in Coase (1937). But whereas internalization theory considers the relative efficiency of internal and external markets for intermediate products, transaction cost theory is more micro-analytic and focuses on the transaction as the basic unit of analysis. Hennart (2001) emphasises that the price system and hierarchy are two alternative methods of organising transactions between agents, and highlights the transaction (information, bargaining, and enforcement) costs involved in organising interactions between agents who are both boundedly rational and (at least some of whom) are opportunistic. Furthermore he stresses that these transaction costs vary according to whether the transaction is organised through the price system or through hierarchy. The price system will be an efficient method of organization when all outputs can be accurately measured (so that they accurately convey the value of goods and services to all agents), and if there are enough buyers and sellers so that prices are exogenous (and thus opportunities for bargaining are eliminated). But if outputs are difficult to measure, and small numbers of buyers and sellers render prices endogenous, then the combination of bounded rationality and opportunism means that monitoring and enforcement costs will be high, and hierarchy will be the favoured method of organization. The agents will be recruited on employment contracts (and thus become employees), and a centralized system of managerial directives will replace a decentralized price system. Agents will be rewarded based upon their behaviour (i.e. for obeying the directives), though there will also be limits to the efficiency of hierarchy because management has to be able to monitor effectively this behaviour.

Hennart (2001) suggests that the conditions favouring cross-border hierarchical organization (i.e. the creation of an MNE) exist *a fortiori* when the agents wish to effect the transfer of knowledge between countries. The markets for knowledge suffer from information asymmetries which give rise to the various problems identified above, and hence transfer under common control within the MNE is the efficient solution because both the provider and the recipient of the knowledge then benefit from effective transfer. In short, 'MNEs thrive when they are more efficient than markets and contracts in organizing interdependencies between agents located in different countries' (Hennart, 2001: 132).

Notwithstanding their differences in emphasis, both internalization theory and the transactions cost theory see the MNE as a response to market failure. Both approaches assert that firms internalize cross-border operations and thus become MNEs when they can thereby lower the costs of organizing and transacting business (Teece, 1986). Both approaches thus see cost minimization through the <u>efficient</u> exchange of intermediate products as the primary objective of the firm.

The Evolutionary Theory of the Multinational Enterprise

The evolutionary theory of the MNE has its origins in the resource-based and knowledge-based views of the firm. Kogut & Zander (1993) maintain that firms are social communities, and repositories of tacit knowledge embedded in their employees and in firm routines. They emphasise that firms compete on the basis of their knowledge and information, and on their ability to develop new knowledge through experiential learning, and that the possession of such ownership advantages (superior capabilities) is the primary explanation for FDI. Furthermore, they stress that the cross-border transfer of knowledge is not costless, and the inherent difficulties and associated costs rise the more tacit is the knowledge. The cross-border transfer, recombination and exploitation of tacit knowledge can thus be accomplished most efficiently within the MNE. Kogut & Zander (1993: 625) thus take issue with the internalization and transaction costs explanations of the MNE, and assert that the 'multinational corporation arises not out of the failure of markets for the buying and selling of knowledge, but out of its superior efficiency as an organizational vehicle by which to transfer this knowledge across borders.'

Notwithstanding the Kogut & Zander critique of the market failure explanation for the existence of the MNE, it is not clear that the evolutionary theory differs significantly from internalization theory – other than a difference of emphasis. Importantly, in the context of this paper, Kogut & Zander base their theory on the idea that MNEs are <u>efficient</u> mechanisms for the cross-border transmission and exploitation of knowledge.

The Eclectic Paradigm

The eclectic paradigm (Dunning, 1977, 1980, 1988; 1995; 2000) embraces the key insights of internalization/transaction cost theory, but also includes elements of trade theory and the resource-based view. It is an attempt to provide a unified framework to explain the choice between FDI, exports and licensing as alternative modes of internationalization, and is couched in terms of ownership, location, and internalization (OLI) advantages. Ownership advantages are specific to the individual firm, and provide the firm with a competitive advantage relative to its rivals and which enables it to offset the additional costs and risks (relative to indigenous rivals) of operating in foreign countries. Location advantages are specific to particular countries, and relate to why one country may be preferred to another as a production site: Dunning lists *inter alia* transport and communications costs; government interventions; controls on imports (including tariff barriers); tax rates, incentives, climate for investment, and political stability; infrastructure (commercial, legal, transportation); and psychic distance. Internalization advantages refer to the benefits from circumventing transactional market imperfections, and coordinating cross-border activities within the firm rather than relying on arm's length contractual arrangements. FDI is assumed to occur (and hence the firm becomes multinational) when the firm possesses ownership advantages, production in a foreign location is preferable to home country production (hence FDI is preferred to exports), and there are significant internalization advantages (hence FDI is preferred to licensing). Dunning (2000a: 167) concedes that initially 'the eclectic paradigm primarily addressed static and <u>efficiency</u> [emphasis added] related issues', but claimed that his later extensions gave more attention to dynamic considerations.

Comments on the Traditional Theories

The role of firm-specific advantages (FSAs) differs subtly in each of the traditional theories. Such FSAs are central to the market power theory, the evolutionary theory and the eclectic paradigm, as they provide the underlying asset-exploiting rationale for why the firms are contemplating the establishment of production in foreign countries. In contrast, the possession of FSAs is not considered a prerequisite for becoming an MNE in internalization theory and the transaction cost theory, as internalization advantages alone are considered to provide a sufficient basis for an MNE to supersede less efficient market transactions. FSAs are still an important part of the story, however, but both internalization theory and the transaction cost theory effectively conflate the asset-exploiting and asset-augmenting motivations for FDI and so provide little guidance as to which party will take the initiative in internalizing the transactions.

But the five traditional theories also have many complementarities and similarities. First, all five theories address the issue of the alternatives to production overseas by the MNE. The market power theory contrasts overseas production by the MNE (or by a licensee) with production by a local firm, which is replaced in whole or in part by the presence of the MNE/licensee. The eclectic paradigm considers the choice between exports, licensing and FDI as alternative modes for servicing the overseas market. In contrast, both internalization theory and the transaction cost theory provide parsimonious explanations of why MNEs arise rather than overseas production being effected through a licensing arrangement. Our discussion below will follow in this tradition and consider the advantages and disadvantages of FDI (and hence the MNE) in comparison to the possible strategic alternatives. Second, the firm in each theory is conceptualized as a decision-making entity, with no consideration given to the different objectives, risk attitudes and decision-making time horizons of important stakeholders – notably the shareholders. Yet the shareholders, and especially controlling shareholders, do exert influence on strategic decision-making. Consider a state-owned enterprise that is privatised, or a private firm that is nationalised. Do we expect the same strategic decisions to be made in each firm before and after the changes in ownership? Alternatively, consider two firms with identical resources, capabilities etc. – one has widely-dispersed share ownership, whilst the other is family-owned. Do we expect the same strategic decisions to be made in each firm? Third, each of the theories envisages the cross-border scope of the firm as determined by short-term <u>efficiency</u> considerations. Yet efficiency in a decision-making context needs also to take account of the varying objectives of the various stakeholders, their attitudes towards risk, and their decision-making time horizons.

ASSET-EXPLOITING AND ASSET-AUGMENTING FDI

We have noted above that asset-exploiting FDI and asset-augmenting FDI are different strategies, and need to be considered separately. The traditional theories of the MNE were all formulated primarily to explain asset-exploiting FDI by firms with significant FSAs, whilst a more recent literature has addressed the asset-augmenting FDI undertaken by many EMNEs[5]. For instance, Mathews (2006: 9) stressed that EMNEs from the Asia-Pacific had not possessed significant FSAs, but emphasised that ‘latecomer firms see the world as full of resources to be tapped, provided the appropriate complementary strategies and organizational forms can be devised.’ In a similar vein, Luo & Tung (2007) highlight the competitive disadvantages of many EMNEs, and suggest that these latecomer EMNEs use internationalization as a “springboard” to acquire strategic assets (e.g. technology, brands, managerial expertise, and distribution channels) overseas, whilst simultaneously reducing their vulnerability to market and institutional constraints at home. Child & Rodrigues (2005) focus on Chinese MNEs, and also suggest that the extant IB theory is too wedded to the idea of prior competitive advantage as a necessary condition for internationalization.

Two points need to be emphasized. First, asset-augmenting FDI is not the sole preserve of EMNEs but may also be undertaken by MNEs from advanced economies. Equally, asset-exploiting FDI is not the sole preserve of MNEs from advanced economies. This raises a broader issue (which will not be explored here in depth) as to whether the motivations and behaviour of EMNEs are fundamentally different from those of advanced economy MNEs, and hence whether special theories are required. We think not, and cite the case of a well-known publicly-listed EMNE - Marcopolo SA (the Brazilian bus and coach manufacturer). In a speech to the 2015 EIBA Conference, Mr Jose Rubens de la Rosa (the CEO) repeatedly emphasised that the firm’s main objective was the quarterly return on assets: an answer that would be expected from the CEO of any publicly-listed firm. Second, and more pertinently in the context of this paper, the viable alternative strategies to asset-exploiting FDI and to asset-augmenting FDI are different. These alternative strategies differ in terms of how costs and returns are incurred over time, and hence involve different levels of risk and uncertainty.

In the case of asset-exploiting FDI, the essential theoretical issue relates to the conditions under which the MNE would prefer to internalize overseas production through FDI rather than licensing production to a licensee in the foreign country. At first sight, licensing might be considered the “easy” option as it involves little or no capital investment, can be implemented relatively quickly, and is likely to generate a relatively stable income stream from the licensee through the contract period. In contrast, asset-exploiting FDI involves (potentially quite significant) capital investment in a foreign country and, in the case of greenfield

[5] A second strand of this literature (e.g. Cuervo-Cazurra & Genc, 2009; Ramamurti, 2009) has suggested that EMNEs possess distinctive FSAs that are typically different from those observed in MNEs from developed economies.

investment, a delay before returns are generated. Furthermore, the scale of these returns are likely to be uncertain as the MNE comes to terms with operating and doing business in the foreign country. Even if the FDI is effected through acquisition, there are the inevitable post-acquisition integration issues (Datta, 1991; Ning et al, 2014) which will affect the stability of returns. In short, asset-exploiting FDI is a riskier strategy in the short-term. In the longer-term, however, asset-exploiting FDI provides potential for higher returns, as the MNE has every incentive to transfer its latest technology and expertise to its overseas affiliates, and to expend more effort in building market share and reducing costs. Further benefits may thus arise through scale economies and through organisational learning (Barkema et al, 1997; Contractor et al, 2003). In short, asset-exploitation FDI involves a higher resource commitment in the short-term (and higher risk exposure) than licensing, but should lead to higher expected returns in the long-term.

What are the alternatives to asset-augmenting FDI? It is possible, but unlikely, that a foreign licensor could be found, especially for the types of superior knowledge-based assets and tacit capabilities (e.g. sophisticated technology, management and marketing expertise, well-known brand names) that are typically sought, and there might be additional issues related to the firm's absorptive capacity (Elia et al, 2016). A second alternative might be the acquisition of the requisite assets/capabilities in the domestic economy, rather than venturing overseas[6]. Such a strategy would avoid many of the risks involved in cross-border investment, but would depend upon target firms with the requisite assets/capabilities being available at a suitable price. This alternative may be realistic for firms in more advanced economies, but as the literature on EMNEs cited above suggests, it is likely to be less feasible for firms in emerging economies. A third alternative is the in-house development of the requisite assets and capabilities. However, as March (1991) noted, such in-house development involves explorative knowledge activities, and the "essence of exploration is experimentation with new alternatives. Its returns are uncertain, distant, and often negative. Thus, the distance in time and space between the locus of learning and the locus for the realization of returns is generally greater in the case of exploration than in the case of exploitation, as is the uncertainty." Thus we might expect the returns from in-house development activities to be diffuse, spread over long time horizons, and involve great uncertainty and risk. In contrast, asset-augmenting FDI will be more expensive in the short-term as the MNE will be buying a going concern, and will not only be paying for the assets and capabilities it seeks but also assets and capabilities it does not

[6] We are grateful to one of the reviewers for this suggestion.

require. But the MNE will also have a degree of certainty about the value of the assets and capabilities it is acquiring (if it has carried out due diligence), and about current revenues and costs. Furthermore, the MNE will be able to enjoy immediate returns. But asset-augmenting FDI would not only be an expensive strategy in the longer-term, but might also prove ineffective unless the firm is at the same time able to build up its internal knowledge base (Veugelers, 1997; Tsai & Wang, 2008) and develop absorptive capacity (Cohen & Levinthal, 1990). Firms which are over-reliant on external technology typically have limited abilities to maximise their internal capabilities (Levinthal & March, 1993), notwithstanding the fact that external knowledge acquisition is often a complementary strategy (Cassiman & Veugelers, 2006). We would thus expect firms which have developed in-house their own assets and capabilities to generate higher returns in the longer-term than those that have relied unduly upon asset-augmenting FDI. In short, asset-augmenting FDI involves a higher resource commitment but more stable revenue flows than in-house development in the short-term, but has lower expected returns in the long-term.

CORPORATE OWNERSHIP AND FDI DECISIONS

In their seminal work, Berle & Means (1932) highlighted the separation of ownership and control in many firms, with the shareholders (the owners of the residual cash flows) typically delegating decision-making powers to a small group of professional, expert and committed managers. They also noted the prevalence in the United States, in the early part of the 20th Century, of widely-held firms in which share ownership was typically dispersed among large numbers of small shareholders, and in which effective control was thus exercised by the managers.

This pattern of share ownership endures to a significant extent to this day in the United States, the United Kingdom and other countries with the Anglo-American model of corporate governance. Share ownership is generally widely-dispersed, with low levels of State and family shareholdings though some significant institutional shareholdings. The rights of all shareholders, including minority shareholders are effectively protected by law. Firm managers are monitored by Boards, and incentivised through their remuneration schemes, to act in the interest of shareholders. And an active market for corporate control imposes discipline on all participants. The result is that shareholder wealth maximization may be reasonably assumed to be the paramount objective of firms in these countries, even if there are associated concerns about the impact on strategic decision-making of too much emphasis on short-term measures of financial success.

Now all the traditional theories of the MNE have been developed with reference to the activities of MNEs headquartered in the United States and/or the United Kingdom, and their applicability to MNEs from other countries has only really been called into question since the arrival of EMNEs. It is thus understandable that these theorists have effectively ignored issues related to corporate ownership, and implicitly assumed that all shareholders have a purely financial interest in their investments, that managers act as stewards on behalf of the shareholders (Davis et al, 1997), and have effectively conceptualised the firm as a risk-neutral decision-making entity motivated by short-term efficiency considerations. Strategy formulation is thus independent of the ownership structure of the firm, and managers are assumed to have a purely passive role merely reacting to environmental conditions.

However, La Porta et al (1999) surveyed the ownership structures of a sample of the largest firms in twenty seven wealthy countries, and found that relatively few firms had widely-dispersed shareholdings. They reported that thirty percent of their sample of firms were family-controlled, eighteen percent were State-controlled, and five percent were controlled by financial institutions, but that the shares in only one-third of firms were widely-held. They also reported that widely-dispersed shareholdings were significantly less common for firms in countries with poor shareholder protection – a common feature in many emerging economies. Other authors have since undertaken similar analyses of firms in different parts of the world, and confirm that significant State, family, and financial institution share ownerships are the norm in most countries in the 21st Century.

Our contention is thus that a consideration of ownership structure should be an essential feature of any general theory of the multinational enterprise particularly as the various alternatives to FDI differ in terms of the time patterns of costs and revenues, and in terms of risk and uncertainty. We outline below the elements of such a general theory, beginning with a discussion of the meaning of efficiency in a decision-making context. We then examine the objectives, decision-making time horizons, and attitudes towards risk of different types of shareholders and outline the (potentially divergent) interests of managers.

On Efficiency

We have argued above that all the main theories (implicitly or explicitly) assume that MNEs emerge as efficient responses to their competitive environments. But as Shubik (1978: 121) emphasises, 'efficiency has a multiplicity of meanings and interpretations to different individuals.' He points out that there are various issues involved in understanding efficiency in a decision-making context including:

- Are one or more groups or individuals involved? If there are more than one, are their objectives identical or do they differ?
- Do the various groups and individuals understand enough of the alternatives available so that they are able to formulate reasonable objectives?
- If the various groups and individuals are going to delegate the decision-making either implicitly or explicitly to others, do they trust the honesty and competence of the decision-makers?

Now firms consist of many groups of stakeholders (including the shareholders and the top management team). Furthermore, in MNEs by definition, some individuals within these groups will be located in different countries. Thus it is necessary to consider *inter alia* the following factors in order to understand strategic decision-making in firms:

- The varying objectives and resource commitments of the different stakeholders.
- The appropriate time period, particularly as asset-exploiting FDI, asset-augmenting FDI and the in-house development of resources and capabilities typically do not yield positive returns for some years. Are the different groups more interested in efficiency in the short-term or the long-term?
- All firm, and especially MNE, operations involve various uncertainties so the strategies of the different stakeholders will also reflect their attitudes towards risk. Shubik (1978: 124) notes that one of most important considerations that enters into risk behaviour is whether the individual(s) making the decisions are risking their own money or their livelihood.

Shubik (1978: 122) thus concludes that 'the idealization of efficient economic decision-making by a single individual is a far cry from reality', and calls for an understanding of how overall corporate objectives are perceived, set and evaluated. In principle, corporate objectives – and the strategies to achieve them – should reflect the objectives of the shareholders. But, in many (especially large) firms, it is the TMT that initiates and implements strategy, and the TMT may well pursue its own objectives. However, the scope for such managerial discretion may well be circumscribed by, on the one hand, powerful shareholders and, on the other hand, by an active market for corporate control and product market competition.

The Shareholders

We noted above that significant State, family, and financial institution share ownerships are the norm in many countries. Now such significant shareholders are unlikely to settle for a purely financial interest in their investments, and may be assumed to try and influence corporate (including FDI) strategy (Thomsen & Pedersen, 2000). There is a significant empirical literature confirming the effects of ownership structure on various FDI strategies. However, most of these studies focus on single emerging economies, and none consider FDI against its alternatives – which is the principal focus of this paper.

State shareholders are an important constituency, not just in most emerging economies but also in many developed economies (Pedersen & Thomsen, 1997; La Porta et al; 1999; Claessens & Fan, 2002). UNCTAD (2013: 12) report that state-owned firms account for 80% of the stock market value in China, 62% in Russia, and 38% in Brazil. State-owned shares are typically not traded in many economies, so there is no threat of transfer of control. Furthermore, state-owned firms typically account for about one-tenth of global FDI flows (UNCTAD 2013: 13). State ownership may be exercised at different levels of government, which will typically have different objectives and hence will try to influence firms in different ways. State behaviour may be 'responsive' to public pressures in some countries, notably in democratic advanced countries where civil society is strong and governments are vulnerable to the political process and to the electoral cycle. But in many emerging and developing countries, State behaviour is more 'autonomous' of societal pressures, and key decisions may be taken by a small technocratic elite (Van de Walle, 2001).

In 'responsive' countries, *State* shareholders will typically have short-term domestic objectives other that value-maximization, and these may militate against the expansion of overseas operations: these objectives may include the preservation of domestic employment, the development of the domestic knowledge base and/or the channelling of benefits to those who can provide political support. Asset-exploiting FDI involves expenditure (which has be to financed though taxation) and the returns come in the longer-term, whilst licensing will be preferred as it involves an inflow to government coffers from the outset. Meanwhile, the domestic development of assets and capabilities will entail greater domestic employment in the short-term, improvements in the domestic knowledge base and higher political approval, and will thus be preferred to asset-augmenting FDI. In summary, we would expect that State-owned firms in 'responsive' countries, or firms where the State ownership is significant, are *ceteris paribus* likely to favour (a) licensing to asset-exploiting FDI, and (b) domestic in-house development activities to asset-augmenting FDI. In contrast, State shareholders in 'autonomous' countries are more likely to have a longer-term perspective and to be more concerned with strategic objectives such as building market share in foreign markets and/or securing access to foreign technologies. They may thus favour both asset-exploiting FDI and asset-augmenting FDI, and may even promote them through the provision of financial and political support.

Family shareholders are a second important constituency, not just in emerging economies but in most countries outside the Anglo-American orbit. Wooldridge (2015: 4-5) cites data from the Boston Consulting Group which show that family firms account for over 50% of large firms in India and South-east Asia, about 45% in Brazil, about 40% in France and Germany, and 33% in the United States. Family shareholders may be reluctant to countenance both asset-exploiting and asset-augmenting FDI for several reasons. First, family-owned firms have different values and objectives than non-family firms (Anderson & Reeb, 2003). Family firms are often reluctant to embrace change, preferring stability and direct control (Claver et al, 2009). The more centralised decision-making in family firms may stymie international diversification strategies. Family firms may also be reluctant to invest overseas because international diversification typically involves higher debt levels which may mean a higher risk of loss of control. Higher levels of international diversification may require resources and expertise from external sources, and this too can dilute family control over firm strategy (Gomez-Mejia et al, 2010). Second, the assets of family shareholders are largely committed to the activities of the firm, whilst their equity holdings show limited liquidity. This means that family shareholders have a greater risk exposure than other shareholder constituencies, hence they will tend to eschew the increased firm-specific systematic risk associated with FDI. Third, family-owned firms are often run as private businesses (Thomsen & Pedersen, 2000), to the disadvantage of minority shareholders particularly when there is weak institutional protection of shareholder rights. Scarce resources may be diverted away from potentially valuable initiatives such as FDI. On the other hand, family firms often have longer decision-making time horizons than non-family firms because the current generation of owners typically feel an obligation to create and preserve wealth for the next generation (Chrisman et al, 2005; Zellweger, 2007). On balance, however, we would expect that family-owned firms, or firms where family ownership is significant, are *ceteris paribus* likely to favour (a) licensing to asset-exploiting FDI, and (b) domestic in-house development activities to asset-augmenting FDI.

Financial institutions are a third important shareholding constituency, particularly in more advanced economies. Financial institutions will typically have the expertise, independence, and motivation to monitor firm management, and ensure that they are pursuing strategies that maximise the value of the firms in which they invest (Johnson et al, 2010).

Furthermore, institutional shareholders are likely to have well-diversified portfolios, and thus to be effectively risk-neutral and more willing to accept increased risk exposure. Hence institutional shareholders should favour asset-exploiting FDI over licensing, as FDI is likely to give rise to a larger increase in the value of the firm both in the short-term and the long-term. Equity participation by financial institutions may also provide firms not justwith additional financial resources but also with access to networks in overseas markets, and thus facilitate FDI directly (Gillan & Starks, 2003; Ferreira & Matos, 2008). . There is considerable debate about the impact of institutional investors on firms' innovation activities. Some writers assume that institutional investors look for short-term gains from their investments, and this myopia militates against innovation (Bushee, 1998). Other writers suggest that institutional investors take a more long-term perspective (which should also be reflected in short-term share prices) and not only seek out more innovative firms, but also use their expertise and influence to encourage firms to engage more in innovation (Kochhar & David, 1996). The available evidence tends to support this latter view, hence it is likely that firms with large institutional investor shareholdings will favour firms seeking the greater long-term, albeit rather riskier, benefits expected from the in-house development of assets and capabilities[7]. We thus expect that financial institution-owned firms, or firms where financial institution ownership is significant, are *ceteris paribus* likely to favour (a) asset-exploiting FDI to licensing, and (b) domestic in-house development activities to asset-augmenting FDI.

Our predictions regarding the strategies preferred by MNEs with different ownership structures are summarized in Table 1. Of course, State, family and institutional shareholders may co-exist with minority shareholders in many MNEs, and there may well be multiple and divergent influences on firm FDI strategy. Ownership structures may also be complicated *inter alia* by stock pyramids, cross-shareholdings and dual-class shares which lead to divergences between control rights and cash-flow rights, and which also give rise to potential principal-principal agency problems (Young et al, 2008). Firms may also be affiliated to business groups which are commonplace in many parts of the world: seventy percent of listed companies in Asia are group-affiliated and are often family-controlled, whilst groups in advanced economies are often controlled by financial institutions (Claessens & Fan, 2002: 86). In such cases, the preferred strategies will reflect the relative shareholdings and levels of activism of the various stakeholders, as well as the broader institutional context.

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[7] Bushee (2001) distinguishes between 'dedicated' and 'transient' institutional investors, and the two groups may well have different objectives and decision-making time horizons.

Table 1: Corporate Ownership and Preferred Strategy

Corporate ownership	Objectives, risk attitudes and decision-making time horizon	Asset exploitation	Asset augmentation
Widely-dispersed	* efficiency * risk-neutral * short-term	Most efficient strategy	Most efficient strategy
State-controlled (responsive country)	* domestic objectives * risk-neutral * short-term	Licensing > FDI	In-house development > FDI
State-controlled (autonomous country)	* strategic objectives * risk-neutral * long-term	FDI > licensing	FDI > in-house development
Family-controlled	* long-term wealth maximization * risk-averse * long-term	Licensing > FDI	In-house development > FDI
Financial institution-controlled	* value maximization * risk-neutral * short-term	FDI > licensing	In-house development > FDI

The Top Management Team

Do the managers act as stewards on behalf of the shareholders? In firms where there is a controlling shareholder, then the TMT is likely to be staffed with insiders who promulgate the objectives of their sponsors. But if share ownership is widely-held by many small shareholders, then the TMT has effective control over strategic decision-making within the firm and it is possible that the TMT may pursue their own objectives notwithstanding the fact that they are supposed to be acting in the interest of the shareholders. This opportunistic behaviour is a manifestation of the well-known principal-agent problem (Jensen & Meckling, 1976). Many of the characteristics of FDI projects (e.g. the one-off nature of most projects, the extended time periods, and the cross-border nature of the activities) and the associated uncertainties tend to give rise to information asymmetries and exacerbate these potential agency problems. Furthermore, agency problems worsen in countries where investor protection is weak.

Agency theory suggests several reasons why the managers might not always act in the interests of the shareholders. First, managers may pursue actions such as ‘empire building’ that create private benefits for themselves, even if they reduce shareholder value. Second, managers may favour a ‘quiet life’, and not exert as much effort as shareholders might wish (Bertrand & Mullainathan, 2003). Third, and possibly of most significance in the current context, there is considerable evidence that managers are risk-averse often to the detriment of investment projects with uncertain outcomes. Amihud & Lev (1981) point out that managers’ incomes from their employment typically constitute a major portion of their total incomes. Their income is thus closely related to the performance of their firm, and that the firm’s failure to meet its performance targets may result in managers' losing their current employment and seriously hurting their future employment and earnings potential. Such employment risk cannot be effectively diversified by managers in their personal portfolios, hence risk-averse managers can therefore be expected to diversify this employment risk by promoting projects that stabilize the firm's income stream. They report (Amihud & Lev, 1981: 609-610) empirical evidence suggesting that the behaviour of managers in manager-controlled firms is systematically different from that of managers in owner-controlled firms, and shows more intensive risk-reduction activities. Thus, in situations where control and ownership are separated, managers may be expected to favour strategies with more stable cash flows and less risk, and which generate returns in the short-term as their rewards will typically be linked to short-term performance. There is a considerable literature devoted to the various ways in which managers can be encouraged to act in the shareholders’ interests. In her useful summary, Denis (2001) highlights various governance mechanisms which she classifies as either bonding, monitoring, or incentive alignment solutions, but stresses that these mechanisms can reduce – but never completely eliminate - the principal-agent problem. The above discussion suggests that manager-controlled firms, or firms where the TMT enjoys considerable discretion, are *ceteris paribus* likely to favour (a) licensing to asset-exploiting FDI (because the associated income streams are more stable), and (b) asset-augmenting FDI to in-house development activities (because the associated income streams are more stable, and also because they would preside over a bigger empire).

DISCUSSION AND CONCLUSIONS

Our objective in this paper is to make a contribution to the theory of the multinational enterprise and, in particular, to explain why firms undertake FDI rather than alternative strategies. We would aver that the market power theory, the evolutionary theory, and the eclectic paradigm all provide insightful explanations of asset-exploiting FDI, but that attempts to extend them to accommodate asset-augmenting FDI have not been fruitful. Internalization theory and transaction cost theory provide explanations of which markets are likely to be internalized through both asset-exploiting FDI and asset-augmenting FDI, but have little to say about who will internalize what activities.

We have further suggested that the traditional theories of the MNE all assume short-term efficiency as the prime objective of the firm – whether it is efficiency in building up market share (market power theory), efficiency in exploiting FSAs overseas (evolutionary theory, eclectic paradigm), or efficiency in organizing the cross-border transfer of intermediate goods and services (internalization theory, transaction cost theory). Efficiency is a beguiling concept because it seems incontrovertible that all firms would prefer a more efficient outcome to a less efficient outcome. But efficiency in a decision-making context needs also to take account of the varying objectives and resource commitments of the various stakeholders involved in making the decision, their attitudes towards risk, and their decision-making time horizons. The traditional theories of the MNE abstract away from such considerations, and implicitly assume that the firm is a risk-neutral decision-making entity with short-term objectives. This may be reasonable for firms with widely-dispersed shareholders and passive professional managers operating in countries with the Anglo-American system of corporate governance. But many firms operate under quite different systems of corporate governance, where concentrated shareholdings are commonplace, and markets for corporate control are weak or non-existent. Such systems are commonplace not just in most emerging and developing economies, but also in many advanced economies (e.g. Japan and Continental Europe). In such cases, the traditional theories fail to capture the full complexity of the FDI decision as they typically abstract away from the key features of the corporate governance systems in which the firms operate. FDI typically involves a substantial commitment of resources and uncertain returns spread over an extended time period, and hence has a high level of risk. Different groups of shareholders (State, family, institutions) are likely to have different objectives, different attitudes towards risk, and different decision-making time horizons. All shareholders may favour efficiency, but their notions of efficiency are likely to be quite different and this will thus affect their decisions about whether or not to undertake FDI. Short-term efficiency considerations may well play a role, but longer-term considerations may well be more important. It is also the case that the four groups of shareholders considered here (i.e. family, institutions, responsive State and autonomous State) are unlikely to be homogeneous, and their motivations and behaviour will depend *inter alia* upon various firm-specific characteristics and also upon the social and political environments in their home countries. The traditional theories of the MNE need to embrace this ownership dimension. In a similar vein, Wooldridge (2015: 16) concludes that ‘the most intriguing challenge posed by the enduring success of the family company is to one of the building blocks of modern economics: the theory of the firm.’

The ownership structure of the firm is the key corporate governance dimension in the context of strategic decision-making, though there are potential constraints. When share ownership is widely-held, the TMT may enjoy considerable managerial discretion with regard to the strategic initiatives it wishes to enact, and it may be unrealistic to assume that the managers act as disinterested stewards. Rather agency theory suggests that managers may have their own objectives and, if they have effective control of the firm, may pursue them even if they are counter to the interests of the shareholders. The information asymmetries inherent in FDI decisions, together with their infrequent occurrence of such projects and the long gestation periods, all provide fertile ground for managerial discretion and the associated agency problems. However, in firms whose shares are subject to active trading, the TMT is obliged to maintain a certain level of firm performance, otherwise they may be replaced or the firm itself may become a takeover target (in which case a new TMT and/or directors may well be installed). Notwithstanding the fact that control contests are often time-consuming and expensive, the threat of losing control does impose on managers the discipline not to stray too far from pursuing strategies that maximise short-term returns (Walsh & Seward, 1990; Dalton et al, 2007). This discipline will be all the stronger in MNEs, especially those cross-listed on foreign equity markets, as there will be more potential buyers of the firm’s assets.

But the markets for corporate control of many firms – in developing, emerging and advanced economies – are often far from active due to pyramid share structures, cross-shareholdings, golden shares, voting agreements and the like, and particularly so in many family-controlled and/or State-controlled firms. For instance, Villalonga & Amit (2006) provide evidence to suggest that many family firms are effectively insulated from the market for corporate control. In such cases, the shareholders (and the TMT) are free to pursue whatever long-term or short-term objectives they choose, safe in the knowledge that there is no threat of transfer of control.

Product market competition too has a disciplinary impact upon firms (Machlup, 1967). In the long-term, organizational slack cannot persist in competitive markets, and managerial decisions should be close enough to those that should maximise the value of the firm. As Shleifer & Vishny (1997: 739) note, ‘product market competition is probably the most powerful force toward economic efficiency in the world'. But many MNEs operate in domestic industries characterised by imperfect competition (sustained by economies of scale, government interventions, barriers to market entry, product differentiation etc) and enjoy preferential access to many local resources. In such cases, the firms have a degree of market power, short-term efficiency considerations will be less compelling, and the corporate ownership influences over strategic decisions will tend to endure.

The central message of this paper is that corporate ownership matters with regard to FDI strategies, whether the FDI is asset-exploiting or asset-augmenting. Several avenues for future research may be identified. First, our approach has been purely theoretical, hence some form of empirical testing of the propositions advanced would be welcome. However, this would be far from straightforward, not just because of the extensive list of potential control variables but also because of the necessity of dealing with the endogeneity problem (Hamilton & Nickerson, 2003). Second, we have distinguished between four broad groups of shareholders (i.e. family, financial institutions, responsive State and autonomous State), but these groups are far from homogeneous. For instance, it might be useful to distinguish further between foreign and domestic institutional investors (Ferreira & Matos, 2008), or between 'pressure-resistant' and 'pressure-sensitive' institutional investors (Brickley et al, 1988), or between 'dedicated' and 'transient' institutional investors (Bushee, 2001). Third, in many firms, there may not be a controlling shareholder – hence strategy may well be influenced by the juxtaposition of different types of minority investors.

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